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economic

Review

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Slow Return to the Future

Introduction

The World Bank and the European Commission have issued a two-volume study entitled Federal Republic of Yugoslavia - Breaking with the Past: The Path to Stability and Growth. This lengthy document, about 450 pages in total, is apparently a strategy of transition and development. I say apparently because the focus, as the title indicates, is limited to stability and growth. Indeed, as will be pointed out below, even the achievement of these two goals is treated with some caution and modesty.

In the first volume, the main goals and instruments are determined. Details by sectors are given in the second volume. The study is to serve as background material for the donors' conference, indeed, for a series of donors' conferences in the period till 2004. The first one, to be held in Brussels on June 29th, should consider the FRY financing needs for the year 2001. This covers roughly what the authors call the short–term. The medium–term financing needs should be addressed later and should cover the period from 2002 to 2004. The study discuses the long-term development, i.e., till 2010, but only in general terms and with no precise calculations for the needs for specific financial aid and assistance.

By Federal Republic of Yugoslavia (FRY) only Serbia and Montenegro are meant. Kosovo is not included as it is under a different donors' programme (some statistical information, as that of GDP, does include Kosovo however). The paper does not go into the constitutional and political issues, though it is noted that significant changes are to be expected which would most probably imply the need to adjust the programme contained in this study. In general, no political economic preconditions for the realisation of this programme are considered at all.

This study is wide-ranging and should be studied carefully. In this short essay, only the key strategic idea is discussed.

The Main Goals

There are two sets of goals that the strategy is aiming to achieve. One is contained in the title itself and consists of stability and growth. The other is a more concrete one and consists of three aims:

(i) restoring macroeconomic stability and external balance;
(ii) stimulating growth and creating the basis for a sustainable supply response, and;
(iii) improving the social well being of the most vulnerable and building human capacity.

FRY Basic Economic Indicators	2000	2000 1999	V 2001	V 2001 IV 2001	V 2001 V 2000	I-V 2001 I-V 2000
GDP growth, in real 1994 prices[a]	...	8.4%	...	...	...	...
Industrial Production	...	10.9%	...	0.0%	-6.0%	-2.4%
Montenegro	...	3.7%	...	12.7%	17.8%	2.9%
Serbia	...	11.4%	...	-0.8%	-7.3%	-2.6%
Central Serbia	...	12.0%	...	-4.8%	-11.3%	-6.1%
Vojvodina	...	10.1%	...	7.9%	1.3%	5.3%
Average Wage - Serbia, in DM	93	-11.2%	150	-0.8%	68.9%	72.0%
Unemployment Rate	28.45%	...	30.1%	...	...	...
Montenegro	...	...	40.0%	...	...	...
Serbia	27.60%	...	29.0%	...	...	...
Current account, in USD millions	-1,298	3.2%	...	...	...	...
Trade balance, in USD millions	-1,989	-10.6%	-225	13.4%	31.6%	13.3%
Export - USD million	1,713	15.0%	117	-20.5%	-19.8%	7.2%
Montenegro	157	31.1%	5	-64.0%	-63.6%	-1.6%
Serbia	1,411	13.8%	112	-16.1%	-14.6%	8.6%
Import - USD million	3,662	12.6%	343	-1.1%	7.9%	10.8%
Montenegro	313	-1.0%	3	-29.1%	-88.3%	-74.4%
Serbia	3,035	15.6%	338	0.9%	18.1%	19.8%
Monetary supply (M1), end of period, in DIN billion	29.6	60.7%	41.0	10.7%	117.0%	96.2%
Cash	10.3	39.8%	13.6	10.2%	128.9%	85.2%
Deposits	19.3	74.9%	27.4	11.0%	111.6%	102.1%
Real money supply, end of period, in DM million	1,043	-26.7%	1,366	10.7%	97.0%	69.7%
Hard Currency Reserve, end of period, in USD million	524	76.2%	661	8.9%	...	...
Discount Rate	...	...	1.00%	0.0%	-50.0%	-30.0%
Market interest rate, monthly level	5.84%	37.3%	5.04%	-0.8%	-7.2%	6.9%
Retail prices - Serbia	...	70.0%	...	1.9%	120.0%	116.8%
Cost of living - Serbia	...	79.6%	...	3.5%	125.2%	118.4%
Industrial producer prices - Serbia	...	102.6%	...	3.2%	115.9%	122.3%
Black market exchange rate (din/DM)	25.45	103.2%	30.40	0.3%	34.0%	36.4%

[a] Data refers to FRY without Kosovo.

If these two sets of goals are consolidated, the strategy could be said to aim at stability, sustained growth and increasing welfare and capacity. It is to be noted that the goals that were prominent in previous transition strategies – e.g., market economy, functioning democracy, open society – are not singled out here. Indeed, some of them appear, in one way or another, among the instruments, i.e., among the reforms that are necessary in order to achieve the chosen goals. Apart from the goals chosen not being the usual transitional ones, they are not really developmental ones either. Thus, it is not altogether easy to determine the genre of this document, so to speak.

The Main Instruments

Standard model of international support & domestic reform

Most generally, there are just two instruments the strategy relies on: international support and domestic reforms. In a nutshell, international aid, assistance and investments should be supportive of comprehensive reforms and both together should be conducive to the achievement of the above set goals.

The external financial contribution has been set at more than USD 1.2 billion for the rest of 2001 and at more than USD 2.6 billion for the 2002-2004 period, or at about USD 3.9 billion for the whole period. Its targets are divided in three groups, i.e., macroeconomic management, promotion of growth and social development, which roughly overlap with the three goals indicated above. Among the sources of the financial support in 2001, the dominant ones are those that aim at covering the so-called recurrent costs and technical assistance as well as investments and credits (they are more or less divided equally between these two groups).

The Expected Outcome

Yugoslav economy should grow about 4% per year on average till 2010. With such growth performance, in 2010 Yugoslavia should reach 80% of its 1989 GDP. In 2010, GDP should be about USD 25 billion or about USD 2500 per capita at most (at most because in this calculation Kosovo is included and population growth in Kosovo has been high in the past).

Investment should be higher than domestic savings by about 8% of GDP in 2010 (i.e., foreign financing needs should be around USD 2 billion in that year). The difference between investment and domestic savings is much higher in the years preceding 2010. That means that foreign investment during the whole decade should, as a rule, be somewhere around USD 2 billion per year.

Anticipates twin deficits & slow growth

Public expenditures should be somewhere between 45% of GDP at the end of the period and 48% of GDP in the first half of the period (i.e., in the period ending with the last year of this programme, which is 2004), with the deficit being somewhere between 4% of GDP at the end and 8% of GDP in the first half of the period. The main sources of finance of the deficit should be foreign grants, credits and investments.

Current account deficit should go down from around 6-9% of GDP in the first half of the period to slightly less than 5% in 2010. Debt to GDP ratio should vary somewhere between 75%, 78% and 71%. However, the debt service to export ratio should increase from 7% at the beginning of the period to around 25% at the end of the period.

Retail prices inflation according to this programme should decelerate steadily from 35% in 2001 to 5% in 2010.

An Assessment

The study, in its second volume, is very detailed and puts down almost every aspect of development and transition reform, at least in the area of macro- and microeconomics. There is no point in going into details of these reform suggestions. They are all standard. Perhaps the key assessment is whether "the path" is to "stability and growth" as desired.

The first question is what kind of a path is being charted? This is easily summarised. The path is one of rather high twin deficits – fiscal and current account deficit - over the whole coming decade that must be covered by foreign financial support of various kinds.

From this, the first critical assessment can be made: this is a rather long path to stability. Unlike in most other cases in which macroeconomic stability was taken as a precondition for sustainable growth, here the major sources of macroeconomic instability are tolerated for the period of about ten years.

This could be seen as justifiable if the expected outcome would be high GDP growth. However, the projected growth is rather modest, because it is constrained by these same high deficits. In other words, the programme does not really deliver stability during the period under consideration and the programmed and contained instability stands in the way of rapid growth. If the financial support of the required kind and amount does not materialise, and the study repeatedly argues that the USD 3.9 billion planned for the whole 2001-2004 period are the bare minimum of what is required, than this growth, though not all that impressive, would not be sustainable.

The twin deficits are expected to persist for two reasons. On one hand, as it has already been pointed out, Yugoslavia will have to service a rather high foreign debt even if the currently existing stock of debt is rescheduled at the best possible terms.

On the other hand, and perhaps more importantly, the fiscal deficit is expected to persist because of the realisation of the third main objective, that of increasing social welfare and development of capacity. In the next ten years no radical reform of public expenditures is envisaged, at least as far as their level is concerned. With public expenditures close to 50% of GDP, it is obvious that the tax burden will have to be high even if foreign aid is exceptionally generous. That will sap growth apart from straining stability, though it will probably just sustain rather than lift the existing level of welfare.

Assuming aid dependency from the outset may produce perverse outcomes

A question may be raised why is this type of a programme preferred to a more radical one with a more decisive stress on macroeconomic stability and more far-reaching institutional reforms? This may be based on the implicit evaluation of the public governance capacities and of political stability in Yugoslavia in general. If true, this would also imply an existence of an implicit judgement that Yugoslavia is more of an aid dependent than of a promising transition state and economy.

What does the programme leave the country with?

The final question is what will the country look like after ten years of pursuing this programme? It will still be quite poor and it will be burdened with significant internal and external deficits. It is impossible to assess at this moment whether it will be able to sustain these deficits or will have to rely on foreign support for years to come after this programme expires. The suspicion is that its economy will end up using a lot of foreign money for modest development achievements and will still end up as not being self-sustainable. It would not be bad, especially in view of the not insignificant dangers of aid-dependency, to chart an alternative programme with more decisive stress on macroeconomic stability and with more radical institutional and policy reforms.

The Lessons of Previous Transitions[1]

Transition from a socialist to a market economy has been proceeding in most countries of Eastern and Central Europe for over ten years now. Yugoslavia and Serbia seriously embarked upon the process of transition only nine months ago. The ten-year delay quite certainly represents an enormous loss for Serbia. However, the only positive thing about this delay could perhaps be the possibility to learn from the mistakes of others. As people say, "wise people learn from the experiences of others, while fools learn from their own experiences". Unfortunately, we somehow failed to realize in time where the anachronous national-communist regime of Slobodan Milošević was taking us. At that point, we obviously learned nothing from the experiences of Albania under Enver Hoxha or Romania under Nikolae Ceausescu. Also largely responsible for this was the Serbian intelligentsia, rallied around the Serbian Academy of Sciences and Arts, which, instead of sciences and arts, dealt with the drawing of maps and resettling of populations in the best tradition of the 19th century. Even the economists in this Academy focused more on fantasies about which republic stole more from other republics, than on true economics. For this reason, now, when we are entering the process of transition, we must not allow ourselves once again the luxury of learning from our own mistakes.

This article will present what I consider to be a resume of the basic lessons in transition. Of course, it is far easier to describe than to explain what it is that needs to be done. However, becoming aware of the goal that is aspired to represents the first and necessary step towards its realization. Without a goal and vision, we are sentenced to wandering in the dark.

Four parameters for successful transition

The main relationship determining the success of transition is the relationship between the following four "parameters": macroeconomic stability, privatization, social policy and political stability. Let us take a look at several "axioms" for successful transition.

Macroeconomic stability is not the goal, but the means

Due to the effects of "market fundamentalism" or a dogmatic vision of reality, and also under the influence of international organizations such as the IMF and the World Bank, the goals and the means were inverted in a large number of countries in transition. Macroeconomic stability, reflected in price stability, avoidance of a fiscal deficit, and an excessive balance-of-payments [foreign] deficit, is undoubtedly extremely important, but it is not the goal of an economic policy – it is its means. This means that macroeconomic stability is a condition without which companies and entrepreneurs are unable rationally to do business (since they do not know, for instance, what the prices will be like in a month or two), or to make investments (since a devaluation can destroy a profitable investment overnight). However, macroeconomic stability is not a goal of the economic policy. A goal of the economic policy is an increase in employment and the population's real income.

Market fundamentalism rarely stands the test of reality

How did the goal and the means come to be mixed up? I believe that two things led to this. First of all, a number of economists (especially in former socialist countries), shifting from one extreme to another, went straight from Marxism to extreme laissez-faire. Thus, for instance, Gaidar, "the father of Russian reforms" and the first Russian (post-Soviet) prime minister was once the editor of the theoretical magazine "Bolshevik", only later to become a loud advocate of "market fundamentalism" and even a supporter of Pinoche. Since most economists (whether they belonged to the left-wing, center or right-wing) were unable to implement their ideas while the communists were in power, their theoretical zeal never had an opportunity to face real life and, thus, to be corrected. The moment they received this opportunity they, of course, used it to apply their "market fundamentalism", forgetting that economics is about fine balancing between economic and political requests, and that "fundamentalism", both on the left and the right wing, cannot succeed in the real world. What is more, as the "fundamentalists" had no serious professional or political opposition in the beginning, since the only real opposition coming from the former communists was discredited, and they threw every other opposition into the same basket with communism, the "fundamentalists" did not have to take into account (as they would have in every democratic state) the opinion or interest of the other side, meaning also those who were to lose from the reforms.

The second favorable element for "fundamentalism" was the support it received from abroad. Foreign consultants or international organizations (IMF and World Bank) would never be able to apply such an extreme economic policy – where the means and goal are inverted – in strong democratic countries or countries where there existed relatively large economic knowledge. Thus, for instance, it would be unimaginable, in a "normal" country, after ten years of a constant drop in the social product, like in Ukraine or Moldavia, to continue to advocate those same, totally unsuccessful models of transition. However, if that someone does not have to face angry workers or pensioners, it is, of course easy and ideologically very simple for him (since this requires no additional mental effort) to continue to advocate market fundamentalism, even if it produces such negative results. In other words, consultants are not politicians and they did not have to face political reality. Nevertheless, the weakness of the economic profession in most East European countries meant that their economists (except in countries like Hungary and Poland) were unable to formulate alternative economic reform programs. This can best be seen through a comparison of the international communities' attitude to countries in transition and Asian coun-

[1] Text prepared for the opening of the G17 Institute, on June 25, 2001

Market stability is a means not an end

tries in the midst of their crisis in 1998. The IMF's extreme solutions were modified or rejected in South Korea and Malaysia. These countries' links to influential business and political circles in America also meant that international organizations were unable to lay the responsibility for the failure of reforms on slow or "inconsistent" reforms in these countries. However, the weakness and corruption of power-holders in East European countries opened up the possibility for the blame for the failure of reforms always to be laid on domestic protagonists and their alleged inconsistency in carrying out reforms.

The best examples of an inversion of the goals and means are Moldavia and Bulgaria. Even though both countries have maintained macroeconomic stability for a number of years now, the economic situation is catastrophic. Moldavia has been registering a drop in the social product for a whole decade now. Such a situation would lead to major social unrest and would be politically absolutely unacceptable in any West European country. A similar, albeit less dramatic situation, is the one in Bulgaria, whose economy regularly registers two or three year growth, and then just as long a drop. The failure to understand the difference between the goal and the means has resulted in political instability in both countries and, thus, the undermining of the reforms as well. The communists returned to power in Moldavia at the last elections, while Bulgaria just recently saw the victory of a nebulous coalition of the dissatisfied, rallied around former Emperor Simeon II, whose goals and ability to carry out reforms are totally vague.

Almost half a century ago, German economist Eucken said that "economic stability is not everything, but that without it, everything is nothing". Fortunately, we have, I hope, finally learned the second part of his thought on our own skin, since we experienced probably the largest hyperinflation in world history, something Milošević's regime bestowed on us. Therefore, I believe it is highly unlikely that we will repeat the same experience. But, we now need to "master" the first part of Eucken's statement – namely, that "economic stability is not everything", i.e. that macroeconomic stability is not a goal in itself, but a means necessary for improving social and individual well-being.

The speed of privatization is not important; the development of the private sector is

The main lesson in privatization could be epitomized as follows: "better a little, but good, than a lot, but bad". Here too we can learn from the bad example of the Russian reforms, especially Russian privatization. Apart from economic fundamentalism, which we have just spoken of, the Russian reformists insisted on the importance of the speed of privatization, emphasizing that it is only in this case that the changes would be irreversible. In other words, if privatization is procrastinated, the communists, who could return to power at any moment, would halt the entire process and there would be no transition. Such an attitude was reflected in the famous statement by Gaidar and Fyodorov about the reform government resembling "kamikazes" who were ready to sacrifice themselves, or more precisely their power, in order to carry out privatization as soon as possible. It is possible that a certain number of reformists truly did believe this, but it is obvious that the power and political strength of the communists was overrated. Not in a single case has their return to power (mostly as social democrats) resulted in the reversion of the wheel of history, to the nationalization of ownership.

However, lying behind the logic of speedy privatization (apart from fear of a communist counter-revolution) were two other reasons. The first one was of a "fundamentalist" nature and was reflected in the view that (applying the Coase theorem) it is unimportant how ownership is distributed, i.e. who is to become rich in the "primary accumulation". Namely, when private ownership is secure, it is in the new owners' interest, no matter how they had acquired these assets, to act responsibly, i.e. to maximize their own gain, and thus also "guided by an invisible hand", the gain of the society as a whole. As we know, this did not happen. New owners turned out to be ready to destroy and sell off the companies, take the money and, often, flee abroad (e.g. Gusinsky and Berezovsky). Of course, this can be explained by the fact that the company's discount rate was very low and that, between the uncertain and laborious work of improving the efficiency of the companies they had obtained for a mere trifle, and their sale and flight abroad, they chose the easier option.

Better a little, but good, than a lot, but bad

The second reason was that speedy privatization, carried out in a "shady" manner, was in the interest of the powerful layers of society in those countries. At issue here is, in a way, specializing in a specific talent (a comparative advantage). Those who are talented in making gains through political connections will usually not have talent as true business entrepreneurs. As Kornai pointed out, already at the very beginning of transition, capitalism is a society that develops organically, so that "market bolshevism" which addressed the issue of "building capitalism" in the same manner as "building socialism", on the basis of the "gung-ho" principle, is unsuitable and cannot produce good results. This is precisely why Kornai insisted on relatively slow privatization, considering it far more important to stimulate entrepreneurs so that a true ("organic", and not false) private sector would develop as fast as possible. The experiences of Hungary and Poland – two countries that laid emphasis on the development of a new private sector, and not on the speed of the privatization of the existing socialists companies – show that Kornai was right. Mihail Arandarenko was of a similar opinion, stressing that instead of a paradigm of primary accumulation, which was (implicitly) advocated by the "fundamentalists", there was more reason to speak of a paradigm of Max Weber's "political capitalism", according to which political influence provides for economic success. The battle is, therefore, waged for political influence – so as to make gains and wealth. Unlike Hungary and Poland, we have seen this kind of "political capitalism" in Ukraine, Russia and most countries of the former Soviet Union. That it precisely why in "partnership-type" or "mafia-type" capitalism entrepreneurs do not have much in common with true businesspeople, since they are actually entrepreneurs in the political sphere. In efficient capitalism, the goal of entrepreneurs is better and efficient production, since this provides for larger profit. In "mafia-type" capitalism, the goal of entrepreneurs is to establish political connections, since this is the way to become rich.

And finally, such shady privatizations are not only fatal for economic efficiency. First of all, instead of most of the population turning to entrepreneurship and trying either to work more or create something new, the population's energy is concentrated on the distribution of the already produced wealth. In other words, instead of thinking about what to produce and how to work better, I am using my energy to find political connections in order to get hold of a small portion of the already existing national wealth. Secondly, as such distribution can be the "winning number" for only a small number of people, since the national wealth is too small in order for, let's say, several million people to have some direct benefit from privatization, the fact that a small layer of the population has become rich, while a majority has gained nothing, has its political repercussions. Instead of most of the population supporting privatization, it is rejected and viewed as plunder – "privatization" in the well-known Russian version. Instead of people voting for the reformists, they are accused of stealing, due to which socialist and populist parties return to the scene. Therefore, such privatization directly undermines political stability.

A social policy is no solution

Very often, even here in this country, expectations from social policy are high, and unrealistic goals are placed before it. While the first wave of "market fundamentalists" had no interest in the social policy, the second wave's interest was enormous – but for the wrong reasons.

Economic growth is the best social policy

Namely, they knew that the implementation of a policy of economic stability as a goal in itself, and a speedy and non-transparent privatization in the interest of a small number of people led to large social disruptions: the non-payment of wages or pensions, unemployment, high interest rates that do not allow the development of a new private sector and so on. However, without abandoning these goals, they transferred the task of reducing social tensions onto social policy. In other words, "we will continue with our plunder, but, through some type of redistribution, you should create the kind of situation in which even the poor would get some pittance and stay calm".

This is, of course, absolutely, impossible. When a society is poor – and it quite certainly is poor when the social product and the population's real income continue to drop, while unemployment is on the rise – the state is poor too, and there are simply no funds for a social policy. Let us compare Germany and the Congo. Poverty is, quite certainly, far greater in the Congo. Is there any social policy and support to the poor there? No, not because it is unnecessary, but because there are no funds for this. Only rich countries can allow themselves to care about the poor.

That is why the social policy and social spending must correspond to the country's economic possibilities. It would be an illusion to expect the social policy here, with an income of a thousand dollars per capita – at the level achieved already thirty years ago – to be able to resolve social tensions. The best social policy, at our income level, is economic growth and the reduction of unemployment. It this fails to be achieved, there will be no funds from which to help the poorest.

Without economic stability there is no political stability, and vice-versa

Economic stability is not the same as macroeconomic stability. Economic stability is macroeconomic stability plus economic growth. This means that without this we are unlikely to enter a period of political stability. For this reason it is growth and nothing but growth, following a two-decade period in which Serbia first stagnated (from 1980 to 1989), only for its real income to plunge by almost half (from 1990 to the present), represents an absolute imperative for successful transition and political stability.

Without political stability, there is no economic stability

But, true is also the opposite – that without political stability it is not possible to achieve economic stability. If we prolong indefinitely the present situation of unsettled relations between Montenegro and Serbia, unclear competencies of federal bodies vis-ą-vis bodies of the Republic of Serbia, a continued conflict with the world's most powerful countries (with the further possibility of their constant blackmail), any serious foreign capital is unlikely to enter Serbia. The belief that every, even the smallest problem is resolved either with secession, or autonomy, or early elections, shows a lack of the political protagonists' maturity. Instead of patiently negotiating, without raising political tensions, and through agreements, political parties and their leaders, with their theatrical moves or the further creation of small states in the Balkans (mostly to appease their own vanity) are objectively working on the further destabilization of the region and on driving foreign capital away. For this reason, the Serbian prime minister was right when he described some of these projects as anachronous, and others as frivolous, and when he pointed out that we needed several years of political stability. Without political stability, which also implies a stable government for at least a few years, and not constant elections and new coalitions, it is ridiculous to expect economic stability.

However, it is just as unrealistic to expect a policy of non-transparent privatization (for which there are many indications) or a possible policy of "market fundamentalism" to lead to political stabilization. Such a wrong economic policy will produce greater dissatisfaction among the population (especially since the expectations are very high), it will result in the inability of the social policy to reduce this dissatisfaction (simply because there will be no funds for this purpose), and finally in political instability, and the serious possibility of the socialists (in new, post-Milošević attire) or nebulous populists returning to the political scene. It will be very difficult for us to avoid the fate of the states around us – Bulgaria, Romania, Macedonia – but if we are aware of the problems awaiting us, we can at least try. The task of the G 17 Institute, as I see it, is to point to such challenges, criticize the authorities when, in our opinion, they are conducting bad policy and to define, as much as possible, the ways in which to avoid "the traps of transition".

MACROECONOMIC REVIEW

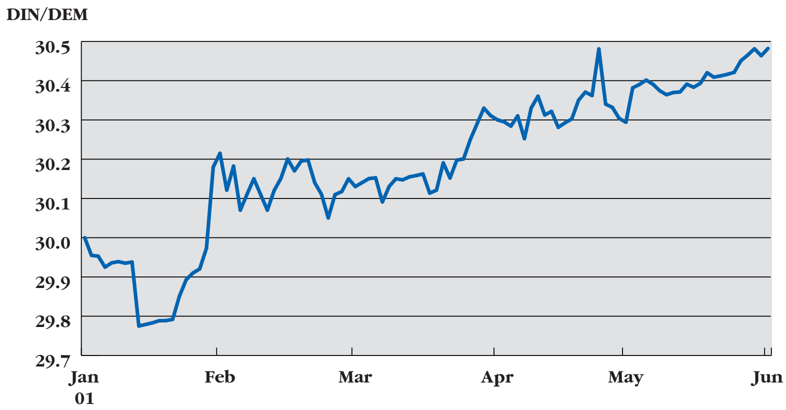
Prices and Wages

The growth of retail prices in Serbia in May was 1.9%. A key element of this growth was a 22.2% increase in the prices of agricultural products. The consumer price index in Serbia was up just over 3.5%, month-on-month. Following a new adjustment of the price of electricity, June inflation will register a somewhat higher rate. Due to yet another correction to the prices of electricity by the end of the year, it is possible to expect inflation at around 45%. Of course, it must be underlined that transferred inflation accounts for a large portion of this.

Net wages in Serbia in May (4,497) compared to April 2001, were down nominally by 0.8%. Expressed in German marks, April wages were worth 150 DEM. The real purchasing power of wages in May (nominal wages deflated by the consumer price index) dropped by 2.6%. In relation to the same month last year (expressed in DEM), the average wage was up 68.9%, while nominal wages deflated by the consumer price index, observed in relation to the same month last year, decreased by 5.4%. The wage average for the first five months of this year was 72% higher compared to the same period last year. As of the next issue, we will be transferring to the new methodology of calculating wages. In the previous system of net wages, 1.05 dinars worth of dues were paid on each dinar of the wage. In reality, the burden was smaller due to the non-taxable part (other forms of payments to employees). According to the finance ministry's estimates, the actual burden was around 0.77 dinars. The new gross wages concept lowers this level to 0.70 dinars worth of dues.

Apart from the usual IMF's request for limiting the expansion of net domestic credit (based on monetary presence in the balance of payments), wages in the state sector (state bodies and companies) will be used as a nominal anchor.

Daily Hard Currency Trends



Output

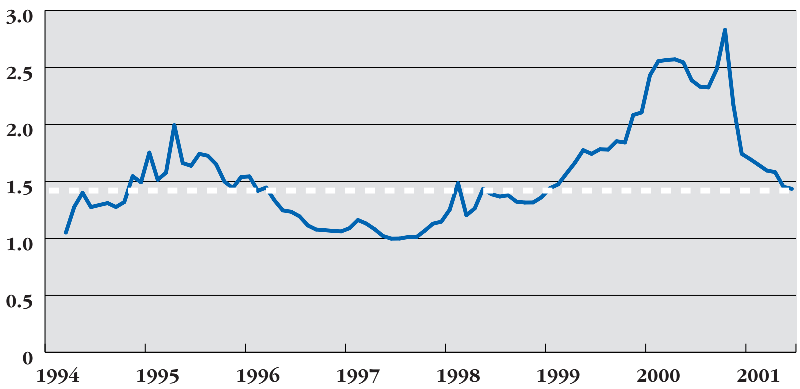
Industrial output in the FRY in May 2001 remained at the same level as in the preceding month. Output in Montenegro increased by 12.7%, and dropped in Serbia by 0.8%. In Central Serbia, output drop was 4.8%, while Vojvodina registered growth of 7.9%. The deseasonalized index for May shows a 2.5% drop relative to April. Such a trend of industrial output can be explained by the negative impact of the imposition of hard budget constraints and the change of relative prices. In the changed environment, some companies are inevitably reducing their production.

Industrial output in the FRY in May 2001 dropped by 6.0% compared to the same month last year under the influence of the same seasonal factors. Output in Montenegro increased by 17.8%, and dropped in Serbia by 7.3%. The output drop in central Serbia was 11.3%, while the growth in Vojvodina is 1.3%.

The adoption of the Privatization Law and accompanying regulations has created conditions for the process of restructuring the Serbian economy. Apart from this, it is also necessary to establish mechanisms for supervising and monitoring income and spending in eight of the largest state-owned companies which employ 6% of the labor force. The salaries in the companies where they are 20% above the republican average have been frozen. Apart from the rationalization of spending, the goal is to enable the rest of the economy to obtain cheap raw materials.

The level of industrial output is stagnating, but this sector was not expected to have a crucial role in contributing to the growth rate this year.

Real Exchange Rate



Foreign trade and the foreign currency exchange rate

In May, Serbia exported goods worth USD 112 million, and exported at the value of USD 338 million. Compared to April 2000, exports were up 0.9%. Over the first five months of 2001, average exports increased by 8.6%, and imports increased by 19.8% compared to the average in the first five months of 2000. Since a surplus of the balance of services is expected this year as well, the current account will register a somewhat smaller deficit. The expected current account deficit (without taking donations into account) will be around USD 1.8 billion, i.e. 17.5% of the official projected GDP.

The foreign currency exchange continued to depreciate in real terms. The two main arguments of the National Bank of Yugoslavia (NBJ) for maintaining this trend is the checking of inflationary expectations and the further existence of a sufficient level of competitiveness of domestic companies, based on historical levels of the real exchange rate. In May (prior to the latest waves of price hikes caused by higher prices of electricity), the real hard currency exchange rate was at the level of 1998 or the beginning of 1996. A comparison of retail prices and the hard currency exchange rate is only one way to express the real hard currency exchange rate. If we were to use only the prices of exchangeable assets (which, for instance, do not include municipal services, which considerably increased this year) or to use only wages for the following period, the situation would be somewhat different, i.e. more favorable. The mentioned figure concerning wages expressed in dinars corroborates this stand. In the upcoming months, one should expect a further slow nominal depreciation of the dinar against the DEM. A potential danger is the slow adaptation of trade to these changes. Furthermore, such a policy must take into account the fact that the beginning of the settlement of the foreign debt implies a prepared exit strategy in case the mentioned slow nominal depreciation is resorted to by the end of the year.

Money, Public Revenues and Expenditures

At the end of May, the M1 monetary aggregate was 41.7 billion dinars. The share of cash at the end of May was 13.6 billion dinars, i.e. 33.1%. After keeping the discount rate at the level of 1% for three months, the National Bank of Yugoslavia (NBJ), guided by the trends of prices and interest, decided to raise the discount rate to 1.9%. The discount rate has been negative in real terms since last October, with the exception of March. The banks' weighted active interest rate on short-term credits was 4.19% at the end of May, while the interest rate was 5.04% on the money market. These interest rates are still relatively high.

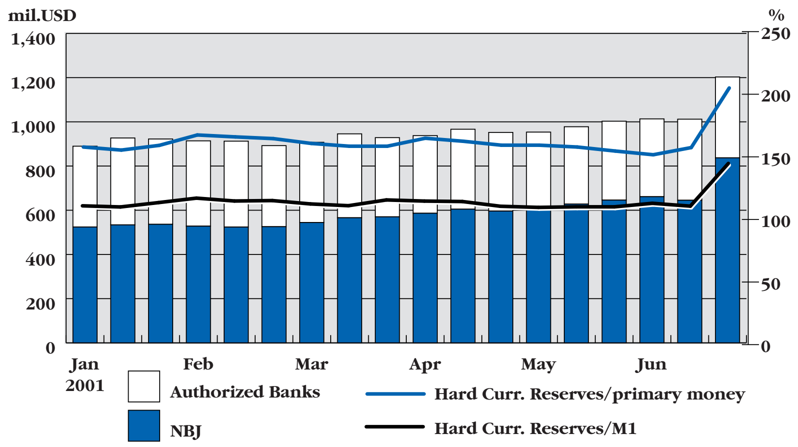
At the end of May, the NBJ's disposable hard currency reserves still fully covered the money supply – the coverage coefficient was 1.11, after which, with the new inflow of hard currency reserves due to the resolution of the issue of succession, this coefficient grew considerably. The level of hard currency reserves at the end of May provided for two months of imports on the average, while the total reserves (NBJ + commercial banks) made possible three months of imports.

Until recently, the exceptionally low monetization level and the use of foreign currency limited the possibility of monetary financing. Furthermore, the change in the structure of the money supply (the reduced share of cash) lowers the possibility of tax evasion. Confidence in the dinar is still being established, but the main sources of the growth of net foreign assets, i.e. hard currency reserves, are the inflow of foreign assistance, a moderate level of imports and the transfer of hard currency transactions from the gray to the legal market.

The gross collection of public revenues is increasing. A total of 23.4 billion dinars (8.9% more than in the preceding month) were collected. The republican budget collected 8.75 billion dinars worth of revenues. This represents a significant increase relative to budgetary revenues in the period prior to the fiscal reform, but a large part of the public revenues (around 40%) in the previous system was financed through special off-budget accounts, so that the growth rates can be taken only conditionally. Following the stabilization of public revenues, Serbia must now resolve the problem of the quasi-fiscal deficit. The quasi-fiscal deficit represents the main obstacle to the establishment of macroeconomic stability. There are two time dimensions of this deficit – resolving the existing and preventing the accumulation of a future deficit. Among the elements of this deficit, apart from the outstanding debts to the budget, are also the losses in public companies. The reduction of the deficit in these companies is carried out through a policy of price adjustment, the abolition of soft financing and the reduction of business costs. There are a number of examples in support of this thesis. The NBJ did not grant the usual credits to the agricultural sector, the effected and planned increases in the prices of municipal services and electricity, and the reduction of the Electric Power Company's (EPS) costs resulting from costs for employees' wages.

The gradual adjustment of the price of electricity, which is higher than announced in the first quarter, resulted in a higher inflation rate, but it was, at the same time, a request of the IMF. The price formed at this level makes it possible to cover most of the costs of doing business, thus also preventing the creation of a more significant quasi-fiscal deficit. The second request of the IMF which remained unfulfilled prior to the talks – the regulation of the debt towards the European Investment Bank, has also been resolved.

Disposable NBJ Hard Currency Reserves, Hard Currency Reserves of Authorized Banks and the Coverage of M1 and Primary Money with Hard Currency Reserves

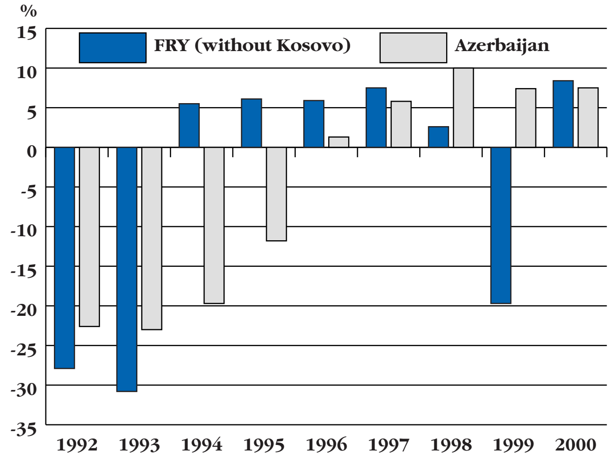


The draft agreement on the succession of republics of the former SFRY was adopted at the end of May. According to the agreement, 38% or USD 1,024 million belongs to the FRY. Nevertheless, since a considerable part of this sum is in the form of claims in joint venture banks which are insolvent, it is realistic to expect the sum of USD 378 million in the form of monetary gold and hard currency in foreign banks, as well as the mentioned share in joint venture banks, if they are solvent. This amount does not include the claims from Russia resulting from the clearing account. At issue is the total sum of around USD 1.5 billion.

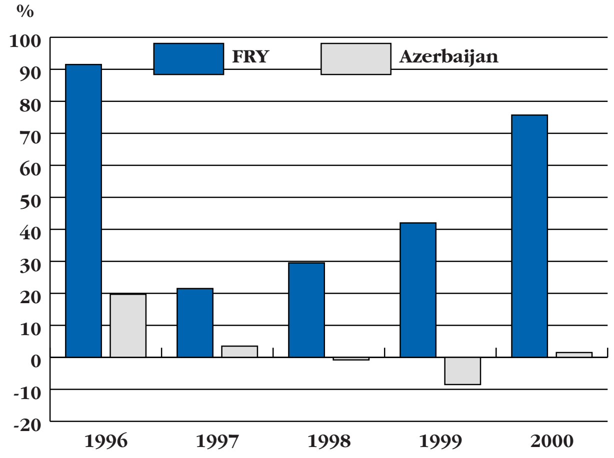
The key economic event, apart from the donors' conference, will quite certainly be talks with creditors on which the manner in which the foreign financial gap is to be bridged will depend, and on which, in turn, long-term economic growth will depend.

Yugoslavia in the mirror of Eastern Europe

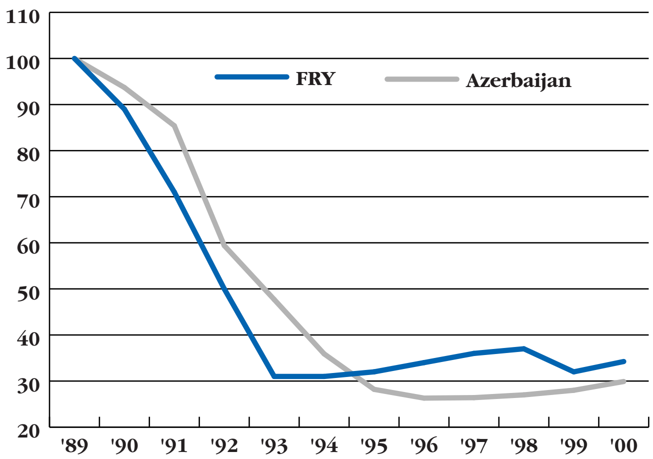
GDP per capita



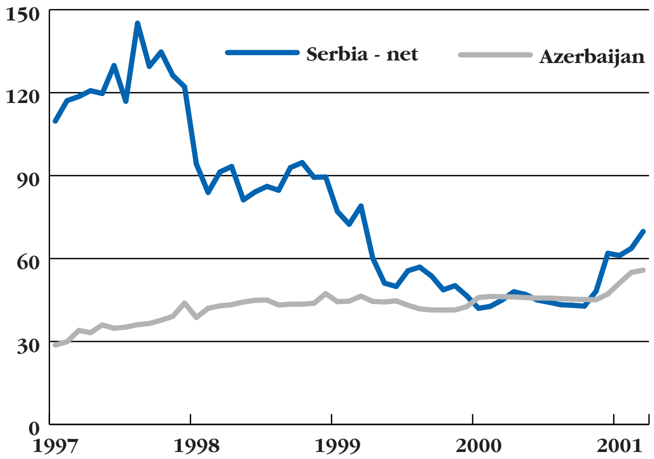
Annual Inflation - Retail Prices



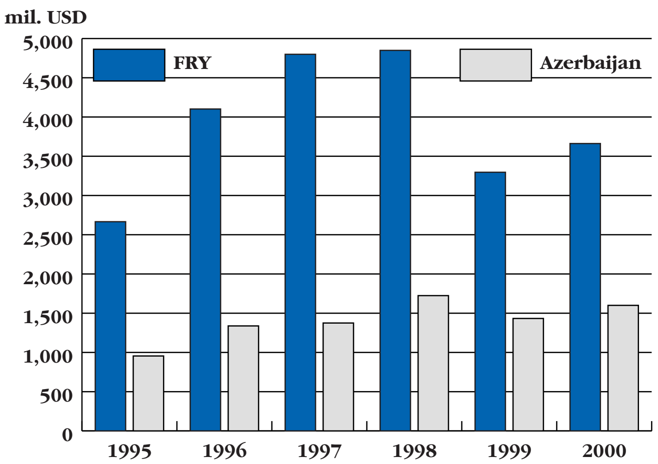
Industrial Production 1989 = 100



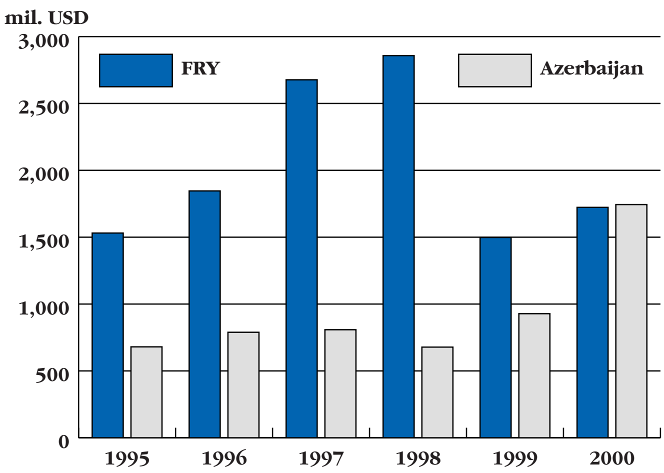
Wages



Import



Export



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